CONCRETE THOUGHTS

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The Paradox of Diamonds and Water

Adam Smith's groundbreaking treatise hints at real estate's current supply-and-demand imbroglio

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Do you remember college? Do you remember Economics 101? In Econ 101, we studied Adam Smith's famous Paradox of Diamonds and Water. Even though life cannot exist without water and can easily exist without diamonds, diamonds are, pound for pound, vastly more valuable than water. Marginal-utility theory of value resolves this paradox—scarcity of goods is what causes humans to attribute value. If we had an unending abundance of both water and diamonds, we probably wouldn't value either very much.

The diamonds and water analogy is representative of quintessential supply and demand fundamentals. An acute supply and demand imbalance in New York's building sales market (an extraordinarily low interest rate environment is also a key) is creating dynamics that are perplexing to many of us active in the building sales sector as properties are currently selling for more than they probably should be.

The volume of sales is up more than fourfold from the doldrums of 2009, increasing from $6.2 billion in 2009 to about $27 billion last year. However, this total remains well below the 2007 peak of $63 billion. The main reason volume hasn't been higher is due to a severely supply-constrained environment. Dollars are water and buildings-for-sale are diamonds. This dynamic continues into the second half of 2012, as significant stockpiles of capital continue to fight over a very scarce supply of available properties for sale.

To fully appreciate the extent of our supply-constrained environment, we must consider that there is rarely a plentiful supply of available properties for sale in New York. Going back 26 years, the average turnover rate, within the statistical sample of approximately 165,000 buildings, has been only 2.6 percent. This is a remarkable statistic that indicates that, when a property is purchased, the average holding period of that asset is approximately 40 years.

While supply has been constrained, the demand side has been booming. During the bubble inflating years of 2005-2007, much of the run-up in prices was caused by the massive amount of institutional capital that was seeking real estate investments. When we started to tangibly feel the credit crisis in the summer of 2007, this institutional capital all but evaporated from the market.

In fact, more than 95 percent of the transactions we closed from the summer of 2007 through the end of 2009 were purchased by high-net-worth individuals and the old-line New York families who have been investing in New York City properties for decades. After a noticeable hiatus from the landscape, institutional capital saw a resurgence in 2010, as many of these investors have formed distressed-asset buying funds or opportunity funds to acquire real estate. This capital is very active in today's market.

Additionally, we have seen high-net-worth foreign investors come into the marketplace in numbers not seen since the mid 1980s. Demand from this sector has been stimulated by the perception that while our economic and political status is somewhat uncertain, they are much more stable than those seen around the globe. A flight to safety has created overwhelming demand for commercial real estate assets in New York from foreign buyers.

Direct foreign investment in a normal year probably averages around 10 percent to 12 percent of all transaction volume. Indirect investment, in the form of equity financing, is more difficult to peg given its covert nature. Based upon what we have seen thus far in 2012, we expect direct foreign investment to double this year, to about 20 percent.

This foreign interest has emanated from all over the globe, but it appears our main trading partners are providing the lion's share of this foreign capital, led by Canada and Mexico.

For these reasons, supply and demand dynamics are completely imbalanced today. This is the main reason dozens of offers have been obtained on every income-producing property we have sold recently and why many assets are trading for more than their asking prices.

Without a doubt, it will be very interesting to see what happens to prices as supply inevitably increases. We believe that fear of capital gains tax increases will bring a flow of properties to market in the second half of the year, but this will not be impactful enough to satiate the overwhelming demand. However, the extent to which dollars continue to be water and buildings-for-sale continue to be diamonds will help determine the direction and magnitude of pricing in the future.

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